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In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. [redacted] 8

CRANE-JOHNSON COMPANY,
a corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF ON BEHALF OF WARREN TELEPHONE COMPANY AND PEERLESS ELECTRIC COMPANY, AMICI CURIAE.

H. H. HOPPE,
Second National Building,
Warren, Ohio,
Counsel for Amici Curiae.

HOPPE, LEA, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. 584.

CRANE-JOHNSON COMPANY,
a corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Defendant.

BRIEF ON BEHALF OF WARREN TELEPHONE COMPANY AND PEERLESS ELECTRIC COMPANY, AMICI CURIAE.

STATEMENT.

Warren Telephone Company, an Ohio corporation, was incorporated in 1926, but did not commence business until July 1, 1928. As of December 31, 1935 Warren Telephone Company had a deficit in capital account of $47,131.49. Its income for the year 1936 was $29,028.97, the normal tax upon which was $3,413.77. Notwithstanding the fact that the income of Warren Telephone Company for the year 1936 was insufficient to make up the deficit in capital account, the Commissioner of Internal Revenue has assessed a surtax against the Warren Telephone Company for its failure to distribute its earnings in the year 1936, claiming the right so to do by virtue of the provisions of Sections 14 and 26(c)(1) of the Revenue Act of 1936. Such additional assessment is in the amount of $5,251.12. From such assessment an appeal has been filed with the Board of Tax Appeals and the cause is now there pending, Docket No. 98,115.

The Peerless Electric Company, an Ohio corporation, was incorporated in 1929. As of the end of its fiscal year November 30, 1936 it had a deficit in capital account of $59,751.84. Its income for the fiscal year ending November 30, 1937 was $41,370.25, the normal tax upon which is $5,039.72. Notwithstanding the fact that the income of Peerless Electric Company for the fiscal year ending November 30, 1937 was insufficient to make up the deficit in capital account, the Commissioner of Internal Revenue is proposing to assess a surtax against Peerless Electric Company for its failure to distribute its earnings in the fiscal year 1937, claiming the right so to do by virtue of the provisions of Sections 14 and 26(c)(1) of the Revenue Act of 1936. Such proposed assessment is in the amount of $7,174.37. A protest to such proposed assessment has been filed and the matter is now pending in the office of the Internal Revenue Agent in Charge at Cleveland, Ohio.

In each of these tax years, the statutes of the State of Ohio permitted a corporation to declare dividends only out of the excess of its assets over liabilities including stated capital. (See Section 8623-38 of the General Code of Ohio set forth in the appendix hereof, page 9.)

The directors of a corporation who declare dividends otherwise than as permitted by Section 8623-38 of the General Code, render themselves personally liable to the corporation for the amount of such dividends, and every shareholder who receives such dividend, knowing it to be paid in violation of Section 8623-38, renders himself liable to the corporation for the amount thereof. (See Section 8623-123b of the General Code of Ohio set forth in the appendix hereof, page 11.)

Section 26(c)(1) of the Revenue Act of 1936 permits a corporation, in determining the amount of its adjusted net income subject to surtax, to deduct an amount equal to the amounts which it could not distribute during the

taxable year as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

POSITION OF AMICI CURIAE.

The position of the Amici Curiae is that:

(1) The statutes of the State of Ohio which prohibit the payment of dividends are written provisions of corporate charters,

(2) Corporate charters are written contracts between the corporations and the State of Ohio,

(3) The statutes of the state which are written provisions of such contract not only expressly deal with the payment of dividends, but, under the circumstances, absolutely prohibited the payment thereof, and

(4) As neither Warren Telephone Company nor The Peerless Electric Company could have distributed any part of their income in the years in question without violating the statutes of the State, which are written provisions of its charter contract with the State, they are not subject to the surtax which in the case of Warren Telephone Company has been assessed, and in the case of The Peerless Electric Company, is proposed to be assessed.

BRIEF.

It is idle to cite authorities in support of the statement that a corporate charter is a contract. This principle of law was recognized by the United States Circuit Court of Appeals in its decision in the case at bar, but for some reason and without citing any authority therefor, it stated that the charter was a contract "for some purposes." (105 F. 2nd 740, 743.) We know of no authorities which hold that a corporate charter is a contract only "for some purposes." We have been able to find no authority which for

any reason puts any limitations upon the rule that a corporate charter is a contract.

In the course of its opinion the United States Circuit Court of Appeals said (105 F. 2nd 740, 743):

> "Here, the Articles of Incorporation and such certificate as may have issued on the organization of the corporation contain no provision restricting dividend payments. It is necessary, therefore, to look to the statutes of North Dakota for the restriction, and to determine whether the state law of North Dakota is a written contract executed by the corporation."

What the court undoubtedly meant by this statement is that, ignoring all other matters, there is no provision to be found within the four corners of the charter that restricts dividend payments. That this is what the court meant is shown by its further statement:

> "These statutes, we think, do not establish a contract executed by the corporation expressly dealing with the payment of dividends. If there is such a contract it is not an express one but is implied."

Section 26(c)(1) of the Revenue Act of 1936 does not require the provision that restricts dividend payments to be an "express" provision. It merely requires that the provision (without saying whether it should be express or implied or incorporated by reference) must "expressly deal" with the payment of dividends. The word "expressly" does not modify the word "provision." It modifies the word "deals."

It is not contended that the statutes are a written contract executed by the corporation. The contention is that the State has by statute provided for the transaction of business in corporate form. Those who desire to take advantage thereof voluntarily file a charter with the State, and the preamble to all such charters reads in substance:

> "We, the undersigned, desiring to form a corporation for profit under the general corporation laws of the State of ..... do hereby certify"

When such charter is accepted by the State a contract arises and the laws of the State are as much a part of it as is the provision of the charter which states, "The name of the corporation shall be XYZ Corporation."

Thus the laws of the State are expressly a part of the charter and we do not have to resort to the principles of inclusion by implication. Further, and even though we did have to resort to such principles, there is nothing to be found in Section 26(c)(1) which forbids the written provision expressly dealing with the payment of dividends to be incorporated in a written contract by implication only. Section 26(c)(1) requires

> (1) a written contract executed prior to May 1, 1936;
>
> (2) a provision of such written contract (whether expressly set forth in the contract or incorporated therein by reference is not specified) which expressly deals with the payment of dividends.

Thus, we respectfully submit the Circuit Court of Appeals erred when in the case at bar it said (105 F. 2nd 740, 743):

> "The corporation itself has made no written contract affecting its right to declare dividends."

The Commissioner in Article 26-2 of Regulations 94 says:

> "The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26(c)."

Here the Commissioner himself recognizes that a corporate charter is a written contract, but takes it upon himself to say that it is not the kind of a written contract Congress had in mind. Yet Congress did not differentiate be-

tween types or kinds of contracts that restrict dividend payments. It provided that any kind of written contract, a provision of which expressly deals with the payment of dividends, is sufficient to give the credit provided for. Respondent's regulation is so obviously in conflict with the law as to be void and of no effect.

As is pointed out on page 16 of petitioner's brief, the Commissioner has ruled (I. T. 3152, C. B. 1938-1, p. 155) that where a restriction on the payment of dividends is found in the stock certificates, there is a contract restricting the payment of dividends within the meaning of Section 26(c)(1). Certainly the statutes of a state are as binding as any provision that may be found in stock certificates. The Commissioner's position is purely technical and without substance when he in effect says that unless the laws of the state restricting the payment of dividends are copied into stock certificates there can be no credit under Section 26(c)(1), but that such credit can be given where they are set forth in the stock certificate. In the very recent case of *Commissioner v. F. & R. Lazarus and Company* (October Term, Cause No. 56) this Court said:

> "In the field of taxation, administrators of the law and courts are concerned with substance and realities, and formal written documents are not rigidly binding."

In substance and reality, the corporation laws of every state are as much a part of the charter and the stock certificates as though they were copied at length therein.

It is indeed difficult to attribute to Congress an intent to impose a tax upon the failure of a corporation to distribute its earnings by way of dividends where such corporation lacks legal power to distribute its earnings. It is hard to conceive that Congress intended to open an avenue whereby the prosperous, healthy corporations, and those most able to pay, might escape a tax, and at the same time intended that such avenue of escape should be closed to

deficit corporations which, because of legal disability, could not take advantage thereof. If Congress had any such intent, then Section 26(c)(1) levies an arbitrary capricious tax that is unconstitutional and void as violative of the Due Process Clause of the Fifth Amendment. On this point the Circuit Court of Appeals in the case at bar said (105 F. 2nd 740, 744):

> "It is further urged that if construed to tax a corporation because it failed to do an unlawful and criminal act, the statute violates the Fifth Amendment. But no North Dakota statute has been called to our attention which makes it a crime to declare a dividend out of capital. Petitioner is urging the court to decide a question of constitutional law based upon a hypothetical set of facts, which is not permissible."

Certainly there can be no distinction between an unlawful act which imposes a personal liability upon directors and shareholders to refund to the corporation unlawful dividends declared and received, and a criminal act which is punishable by fine payable to the state. Thus no hypothetical set of facts was presented to the Circuit Court of Appeals. The real issue is whether a tax which expressly provides an avenue of escape to some, but which avenue of escape is closed to others laboring under a legal disability, is not a tax that deprives the latter of that Due Process of law which is guaranteed by the Fifth Amendment.

The position of respondent when carefully analyzed becomes an absurdity. Let us assume that the directors of a deficit corporation, in contravention of the State law, pay a dividend to its shareholders in amount equal to its earnings for the taxable year in question. The corporation having so distributed its earnings would, according to respondent, obtain the credit provided for in Section 26 (c)(1). Assume further that in so distributing its earnings the shareholders are advised that the distribution is

in contravention of State Statutes and that they might be required to pay it back. (See *Ulness v. Dunnell*, 61 N. D. 95, 237 N. W. 208.) Assume further that in the same taxable year the shareholders are required to and do pay such dividend back to the corporation. It has escaped the tax. The shareholders report for income tax purposes the receipt of the dividend and likewise report as a loss the return of the dividend perforce of the State statute. The shareholders thus escape a tax on the dividend and the very purpose Congress had in mind of imposing the tax is defeated. Certainly we cannot say that Congress ever intended such a situation to prevail.

We respectfully submit that the decision of the United States Circuit Court of Appeals in the case at bar is erroneous and that the petition for writ of certiorari herein should be granted.

Respectfully submitted,

H. H. HOPPE,

Counsel for Amici Curiae.

HOPPE, LEA, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

APPENDIX A.

General Code of Ohio.

G. C. §8623-38. *Dividends.* (a) A corporation may declare dividends payable in cash, shares, or other property out of the excess of the aggregate of its assets less the deductions hereinafter required over the aggregate of its liabilities plus stated capital.

(b) In computing the excess of the assets, deductions shall be made for depletion, depreciation, losses and bad debts. In computing the excess of assets for the purpose of determining the fund available for a dividend payable otherwise than in shares of a corporation deduction shall also be made for the unrealized appreciation, if any, appearing on its books unless the amount thereof shall have been transferred to or included in stated capital. If its articles so provide, a corporation whose business consists substantially of the exploitation of wasting assets, may pay dividends without making deduction for the depletion of such assets resulting from lapse of time or from the consumption or sale of such assets incidental to their exploitation.

(c) No corporation shall declare or pay a dividend in cash or other property when there is reasonable ground for believing that it is unable or, by the payment of the dividend, may be rendered unable to satisfy its obligations and liabilities.

(d) Whenever a dividend is paid, in whole or in part, out of other than earned excess of assets appearing on the books of the corporation at the time of the declaration of such dividend, the shareholders receiving such dividend shall be notified as to its source.

(e) Whenever two or more corporations have heretofore been or shall hereafter be consolidated or merged (pursuant to section 8623-67 of the General Code or by purchase) or whenever a corporation has heretofore been or shall hereafter be reorganized, the earned excess of assets appearing on the books of the constituent or merged corporations or on the books of a corporation prior to

reorganization, may, to the extent that it is not capitalized, be entered as earned excess on the books of the consolidated corporation or on the books of the corporation into which the other or others are merged, or on the books of the reorganized corporation, and thereafter may be treated as earned excess.

A corporation may, by action of its board of directors, apply any part or all of any paid in surplus or any excess of assets however created or arising excepting only surplus arising from revaluation of assets, to the reduction or writing off of any deficit in the account of earned surplus or to the writing off of any particular loss or expense or to the creation of a reserve or reserves for any proper purpose and thereby make available for dividends without notice to the shareholders as to the source of such dividends any earned excess of assets remaining or resulting therefrom or thereafter arising, but in case such action is taken a disclosure thereof shall be made in the next annual statement of the corporation.

Any excess of assets hereafter arising otherwise than from the earnings of a corporation shall be classified according to its derivation and so shown in separate accounts.

(f) Nothing contained in this section shall prevent the directors of a corporation from setting apart out of the excess of assets available for dividends a reserve or reserves for any proper purpose or from abolishing any such reserve.

Whenever the board of directors of a corporation shall be of the opinion that its assets, including patents or good will, have a fair value to the corporation in excess of the amount at which they are carried on its books, and shall determine the amount of such fair value, it may order all or a part of the fair value so determined to be entered on its books and thereby create an excess of assets, which the board of directors may apply to a dividend in shares of the corporation and transfer to stated capital or apply to an increase of stated capital represented by shares without par value.

Any transfer of excess of assets to stated capital shall be deemed to have been made from that part of the excess, if any, which resulted from unrealized appreciation. A

dividend payable in shares without par value may be declared and paid upon the transfer to stated capital of any amount that may be ordered by the board of directors, or, without any change of stated capital, as the board of directors may determine.

No dividend shall be paid to the holders of any class of shares in violation of the rights of the holders of any other class of shares.

G. C. 8623-123b. *Unlawful dividends; penalty.*

The directors of a corporation shall not declare or pay dividends or authorize the withdrawal or distribution of any part of its assets except as provided in this act.

Any shareholder, who shall knowingly accept or receive any dividend or distribution not authorized by this act to be made, shall be liable to the corporation in the amount accepted or received by him with interest at the rate of six per centum per annum until the same shall be repaid.

In case of any wilful or negligent violations of the provisions of this section, the directors, under whose administration the same shall have happened (except those who shall dissent as hereinafter provided), shall be jointly and severally liable to the corporation for the full amount of any such unauthorized dividend or distribution with interest at the rate of six per centum per annum until the same shall be paid.

A director shall not be held to have been negligent within the meaning of this section if he relied and acted in good faith upon the books of a corporation, or upon a balance sheet and profit and loss statement of the corporation and a statement of the assets available for a dividend or distribution represented to him to be correct by the president or the officer of the corporation having charge of or supervision of its accounts, or certified to be correct by a public accountant or firm of public accountants of good reputation, nor shall he be held to have been negligent if in good faith he considered assets at their book values, nor if in any case he followed what he believed in good faith to be sound accounting and business practice.

Any director against whom a claim shall be asserted by or on behalf of a corporation under or pursuant to this

section, or who shall be held liable under or pursuant to this section, shall be entitled to contribution from other directors who are liable, according to the number of such directors, and any and all directors against whom a claim shall be asserted under or pursuant to this section or who shall be held liable, shall have a right of contribution against the shareholders who knowingly accepted or received any dividend or distribution not authorized to be made, and such shareholders shall contribute in proportion to the amounts received by them respectively.